No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. GORDON PHILLIPS and LAURETTA M. PHILLIPS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONERS.

A. L. BURFORD, JR.,
523 West Sixth Street,
Los Angeles 14, California,
Attorney for Petitioners.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

No. 15890

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

N. Gordon Phillips and Lauretta M. Phillips,

Petitioners,

vs.

Commissioner of Internal Revenue,

Respondent.

BRIEF FOR THE PETITIONERS.

Opinion Below.

The opinion of the Tax Court is reported at 29 T. C. No. 7.

Jurisdiction.

This petition for review [R. 45-47] involves federal income taxes for the taxable year 1951. On April 15, 1955, the Regional Commissioner of Internal Revenue at Los Angeles, California, mailed to the taxpayers a notice of deficiency in the total amount of $15,525.59. [R. 8.] Within ninety days thereafter and on June 21, 1955, each taxpayer filed a separate petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939, as amended. The petitions were consolidated for trial. A decision of the Tax Court in each proceeding was entered

on October 16, 1957, for the full amount of the deficiency. [R. 44.] On October 28, 1957, motions by taxpayers for review by the full court were denied. [R. 4.] This case is brought to this Court by a petition for review filed January 9, 1958. [R. 45-50.] Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

Question Presented.

Did the Tax Court err in holding that money received by taxpayers in 1951 from the sale of certain shares of stock owned by a third person was held by taxpayers under a "claim of right" without restriction as to its disposition so that the gain realized from said sale was properly taxable to them in 1951 under Section 22(a) of the Internal Revenue Code of 1939 even though they were later obligated to pay over the proceeds received from such sale to the owner of the stock?

Statute and Regulations Involved.

These are set out in the Appendix, *infra.*

Statement.

The facts as stipulated by the parties [R. 18-22] and as found by the Tax Court [R. 37-41] may be summarized as follows:

Taxpayers are husband and wife. They filed a joint federal income tax return for the taxable year 1951. The income therein reported was community income. [R. 19.]

Taxpayer, N. Gordon Phillips, organized a California corporation in 1949 known as the Gordon Oil Company. He received one-half of the stock of said company consisting of 13,000 shares in consideration for his services and

the transfer to it of certain leasehold interests. The other half of the stock was sold. All of the stock was held in escrow in compliance with the terms of the permit issued by the Commissioner of Corporations of the State of California. [R. 19.]

In August, 1949, taxpayer, N. Gordon Phillips, and G. W. Raichart executed a written instrument under the terms of which Phillips agreed to give Raichart 320 shares of capital stock when received from the escrow "for promotional services rendered." [R. 20.]

G. W. Raichart died on December 27, 1950. On March 21, 1951, pursuant to a sale of all of the stock of said company Phillips received 11,210 shares out of escrow (13,000 shares less 1,790 shares previously transferred) and on or about the same date sold them for $1,689,347.00. The above sale included the 320 shares Phillips had agreed in writing to transfer to G. W. Raichart when received from escrow. The money received for the 320 shares was not remitted to Raichart's estate but was retained by Phillips. [R. 20, 24.]

On February 14, 1952, the executrix of the estate of Dr. Raichart brought an action in the Superior Court of the State of California in and for the County of San Diego for damages for breach of contract against taxpayer, N. Gordon Phillips, with a second count for conversion involving the right to the 320 shares of stock of Gordon Oil Company which were the subject matter of the written agreement dated August 18, 1949. The Court entered judgment against taxpayer in the amount of $49,920.00 together with interest of $6,687.08 and cost of suit of $148.65. It found that on December 27, 1950, the date of Dr. Raichart's death, he was the owner of and entitled to immediate possession of said 320 shares of

stock when released from escrow, and that Valli D. Raichart, as executrix, was entitled to immediate possession of said shares as of January 24, 1951. It further found that on January 24, 1951, taxpayer Phillips unlawfully sold and disposed of said 320 shares and converted the same to his own use and benefit and received the proceeds thereof in the amount of $49,920.00 and ever since then had retained the proceeds. The Court further found that the agreement of August 18, 1949, was signed and executed for a good and valuable consideration and that said agreement had not since been cancelled, changed, modified or extinguished except by the breach thereof by taxpayer Phillips. The District Court of Appeal, Fourth District, California, affirmed the judgment of the Superior Court and the decision is reported in 120 Cal. App. 2d 645, 261 P. 2d 777. Appeal to the Supreme Court of California was denied. [R. 21, Jt. Ex. 2-B.]

Taxpayer paid the judgment together with interest and costs, a total of $56,755.73, in 1953. [R. 22, Jt. Ex. 3-C.]

Taxpayers treated the gain realized on the sale of said 320 shares of stock as their own, reporting the gain from the sale in their 1951 income tax return. [R. 39.] In their 1953 return taxpayers did not claim a deduction for payment of judgment. [R. 40.]

On these facts the Tax Court found that the gain on the portion of the proceeds received from the sale of the 320 shares of stock in 1951 was taxable income to taxpayers for that year even though they were later obligated to return the portion of the proceeds received from such sale. [R. 41.] Mr. and Mrs. Phillips have petitioned the Court to review this holding. [R. 45.]

Attention of the Court is also invited to the fact that a joint income tax return was filed for the year 1951 but

that separate decisions in the full amount of the deficiency were entered against both taxpayers as a result of separate petitions to the Tax Court having been filed. As a consequence taxpayers at the present time are liable for twice the amount of the correct deficiency as found by the Tax Court. This is obviously erroneous as there should be one judgment in the amount of the deficiency constituting a joint and several liability of taxpayers.

Specification of Errors.

1. The Tax Court erred in failing to give proper effect to the state court judgment that the 320 shares of stock were not owned by taxpayers but by a third person at the time of their sale and conversion.

2. The Tax Court erred in holding the gain realized on the sale of the 320 shares of stock taxable to taxpayers in 1951, based on its finding that the proceeds were held by them under a "claim of right" and without restriction as to the disposition of the proceeds.

Summary of Argument.

The Commissioner held that taxpayers were properly taxable in 1951 on the gain realized from the sale of 320 shares of stock which were in fact owned by a third person but which were unlawfully sold and disposed of by taxpayer, who converted them to his own use and benefit and received the proceeds of sale for himself in that year.

The Tax Court sustained this determination. It held this gain taxable to taxpayers on the basis of its finding that the proceeds of sale were held by them in 1951 under a "claim of right" and without restriction as to the disposition of the proceeds of the sale regardless of the fact that taxpayers did not own the stock and were obli-

gated to pay over the proceeds to the owner in a subsequent year.

The Tax Court further held that it was giving proper effect to the judgment of the state court determining the ownership of the stock by stating:

> "* * * The force of the California judgment compelling the payback is recognized and petitioner's complying with the mandate of the judgment will give him a deduction from income in the year it is made."

The proper tax result, based on the state court's determination of the ownership of the stock, is to tax the gain on its sale to the owner and not to these taxpayers. The result of this decision is to tax the gain to taxpayers in 1951 and to tax the very same gain again when paid over to the owner in 1953 with no corresponding deduction. This inequitable result is contrary to the well established rule of law that income follows the property right as determined by the state court.

The actual facts of this case are not in dispute. However, the demarcation between findings of fact by the Tax Court and legal conclusions based on those findings is not clearly delineated in the opinion of the Tax Court. The opinion states that "The facts of this case bring it clearly within the claim of right doctrine." [R. 41.] It further states that since taxpayer retained the proceeds from the sale of stock "under claim of right without restriction as to the disposition of said proceeds he is taxable * * *." [R. 42.]

Counsel knows of no cases involving the so-called "claim of right" doctrine which involve facts similar to those of this case. The above quoted statement that taxpayer held the money under a claim of right and without restriction is an erroneous legal conclusion of the court not supported by the facts. Taxpayer at no time had any right to the proceeds, and they were at all times subject to the restriction of the written agreement with the owner of the stock. The breach of the agreement and the conversion of the shares did not give taxpayer a claim to the proceeds or unrestricted use of them. This is clearly demonstrated by the sequence of events. The stock was converted on January 24, 1951, approximately one month after Raichart's death, but after the appointment of his executrix on January 12, 1951. The complaint for damages for breach of contract, for conversion, was filed February 14, 1952. This was even before the due date for the filing of 1951 income tax returns. [Jt. Ex. 2-B.] Thus this is not a case where the question of ownership of property arose only in connection with a taxpayer's defense to a deficiency or fraud charge in an income tax case and where there was little if any likelihood that the owner would ever attempt to secure possession of the property. As soon as the executrix had inventoried the assets in her husband's estate and determined that the agreement with her husband would not be carried out voluntarily she commenced an action to enforce it. The statutory notice of deficiency was not sent to taxpayers until April 15, 1955, over three years after the suit was filed and after the judgment had been paid, which was in 1953.

Taxpayer's arguments as summarized above will be presented under the following points of law:

I.

The gain realized from the sale of the stock is properly taxable to the owner thereof as determined by the state court in an adversary proceeding.

II.

The application of the claim of right doctrine to the facts in this case does not result in the gain from the sale of the stock being properly taxable to the taxpayers.

(a) This is not a case of when income is taxable but whether taxpayers received any gain or profit from the sale of the stock within the reach of Section 22(a) of the Internal Revenue Code of 1939.

(b) Taxable gain under these facts is conditioned upon the presence of a bona fide legal or equitable claim of right to the alleged gain and the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain.

(c) All relevant facts and circumstances must be considered.

POINT I.

The Gain Realized From the Sale of the Stock Is Properly Taxable to the Owner Thereof as Determined by the State Court in an Adversary Proceeding.

It is clear that the Commissioner is bound by a decision of a state court determining the ownership of property where the litigation is adversary in nature. The question is the proper application of this legal principle to the facts of this case. The Tax Court recognized this rule of law but stated that it was being given full effect as heretofore indicated. It is submitted that the Court erred in this respect.

The proper application of this rule of law is clearly demonstrated by *Estate of A. Bluestein,* 15 T. C. 770 (1950; Acq. 1951-1 C. B. 1). Although also involving estate tax, we are here concerned with the portion of the case dealing with the taxation of the income to the decedent for the period January 1, 1944, to the time of his death on September 18, 1944. Clearly decedent treated all the income as his own. The Commissioner contended that all of it should therefore be taxed to him in his final return. The Texas court had held in an unreported declaratory judgment on March 1, 1945, which was affirmed, that one-half of the property producing this income was not owned by decedent but by other heirs of his deceased wife, namely, sons. The Tax Court stated at page 785:

> "* * * The Texas decree determined that the decedent owned only one-half of the business and the other assets standing in his name and that he held his sons' interests in trust for them. It follows that only the income from the decedent's one-half interest

> should be taxed to him for the period January 1, 1944, to the date of his death on September 18, 1944, and to his estate for the period before us when the estate was in administration, viz., the fiscal years ending August 31, 1945, and August 31, 1946. The income accruing to the sons for their interests during the above periods was paid or credited to them and the decedent or his estate had no legal claim to it."

It is difficult to see how a greater claim of right to property and his income could be asserted than was asserted by decedent in this case. His wife died in 1919. He died in 1944. He had thus claimed property belonging to his sons together with the income therefrom for 25 years. When he died he was still claiming the income. His taxable year 1944 ended before the entry of the judgment of the Texas court on March 1, 1945. None the less the Tax Court had no difficulty in holding that the income followed the property ownership and that the income realized from the property which the court held belonged to the sons should be taxed to them and not to decedent.

The Tax Court opinion indicates that the Texas court determined that decedent held his sons' interests in trust for them. It is clear that this was not a testamentary trust or an express trust. It apparently was a constructive trust. The same would be true in the case before this Court. Section 2223 of the California Civil Code provides that one who wrongfully detains a thing is an involuntary trustee and that he holds it for the benefit of the owner.

If the income claimed by Bluestein until his very death but in fact owned by his sons was properly taxable to the sons, *a fortiori* the gain on the sale of the stock owned by Raichart but claimed by taxpayers should likewise be taxed to the owner of the property.

POINT II.

The Application of the Claim of Right Doctrine to the Facts in This Case Does Not Result in the Gain From the Sale of the Stock Being Properly Taxable to the Taxpayers.

(a) This Is Not a Case of When Income Is Taxable but Whether Taxpayers Received Any Gain or Profit From the Sale of the Stock Within the Reach of Section 22(a) of the Internal Revenue Code of 1939.

The issue in this case is not whether 1951 was the proper year in which to tax the gain on the sale of the stock in question to these taxpayers. The issue is whether such profit ever represented gains or profits to these taxpayers within the reach of Section 22(a) of the Internal Revenue Code of 1939. If there was such gain it obviously was taxable to these taxpayers in 1951.

The so-called "claim of right" doctrine, whatever its shortcomings and limitations in actual application, is now a firmly embedded judicial gloss on the statutory tax structure. However, properly interpreted it is submitted that this concept reaches only to the question of when income is properly reported or a deduction properly claimed under our system of annual accounting periods. As stated by Judge Mulroney in his Tax Court opinion in this case [R. 41] the doctrine had its origin in the well known case of *North American Oil Consolidated v. Burnet,* 286 U. S. 417. No useful purpose would be served by an extended discussion of this case. It should be pointed out nevertheless that it involved a dispute as to title to property. Because of this dispute between the Government and the taxpayer the income from the property was impounded by a receiver in 1916. In 1917 the net profits from 1916 operations were paid over to the taxpayer

by the receiver pursuant to court decree based on the court's decision that the taxpayer had title to the property. Even though the Government appealed and the case was not finally settled until 1922, the Court held the 1916 net profits taxable to the company in 1917 because the taxpayer became entitled to them in that year and actually received them. The fact that the Government might win on appeal was not considered to be a contingency of sufficient moment to warrant the taxpayer's postponing the reporting of the income for tax purposes.

In the last several years there have been a great number of cases involving the claim of right doctrine. These cases primarily involve the correct correlation of recognized business accounting concepts of accrual of income or expense items with the requirements of tax accounting. They have no bearing on the issue before this Court. This is also true of *Michael Phillips,* 25 T. C. 767, aff'd 238 F. 2d 473, cited in the opinion below. [R. 41.] This case involved the proper time for the reporting of a contingent fee received by an attorney in connection with a case which was later reversed. *Healy v. Commissioner,* 345 U. S. 278 cited in the opinion below [R. 41] likewise involved this same general principle and concerned salaries found to be unreasonable in amount. The corporation was unable to pay the tax deficiency. The stockholder-employees who received the excessive salaries paid the corporation's tax deficiency because of their transferee liability. The question before the court was whether the taxpayers were taxable on the entire amount of their salaries in the year paid or whether an adjustment should be made because of the subsequent repayment of a portion thereof. The taxpayers argued that they received the salaries as "constructive trustees" for the benefit of the

creditors of the corporation. The court stated that admittedly receipts by a trustee expressly for the benefit of another are not income to the trustee in his individual capacity. However, the constructive trust in this case resulted from the equitable doctrine that funds of a corporation are a trust fund for the benefit of creditors if received by a stockholder without adequate consideration from an insolvent corporation. There was nothing illegal or unlawful in connection with the salaries and it could not have been said at the end of each of the years involved that the transferee liability would ever materialize. Thus, a potential or dormant restriction on the use of the salaries which depended upon the future application of rules of law to present facts was not a "restriction on use" within the meaning of *North American Oil Consolidated v. Burnet, supra.*

(b) Taxable Gain Under These Facts Is Conditioned Upon the Presence of a Bona Fide Legal or Equitable Claim of Right to the Alleged Gain and the Absence of a Definite, Unconditional Obligation to Repay or Return That Which Would Otherwise Constitute a Gain.

In the case before this Court the taxpayers at no time owned the stock in question. If the owner of the stock had sold it and had paid taxpayers a commission which for some reason such as mistake in computation had later been refunded in part, or if the sale on which the commission was based had fallen through and the commission had been refunded, then the case would have been analogous to those referred to above. Here, however, stock owned by another was unlawfully sold and disposed of and converted to taxpayer's own use and benefit. [Jt. Ex. 2-B, p. 2.]

In short, it is submitted that there was never any bona fide legal or equitable claim by taxpayer to the stock in question within the meaning of that term as used in the "claim of right" cases. This appears to be tacitly admitted by the Court below in its citation of *Rutkin v. United States,* 343 U. S. 130. [R. 41.]

Here if the taxpayer was not holding the stock as trustee for the owner he was at least holding it as bailee for his principal, and he unlawfully converted to it his own use with the intent of depriving the owner of his property unlawfully. There was no occasion here to resort to a constructive trust, referred to by the court in *Healy v. Commissioner, supra, as a legal fiction.* There was a clear breach of a written agreement in this case.

It is submitted that under these circumstances taxpayer never had a bona fide claim of right to the proceeds from sale of the stock, no matter how untenable, nor did he at any time hold the money without restriction on its use and disposition.

If this analysis is sound, a careful consideration of the cases involving taxation of property received as a result of the illegal act of the taxpayer is required. Counsel does not have the temerity to represent that he can satisfactorily reconcile the principles enunciated in *Rutkin, supra,* with those in *Commissioner v. Wilcox,* 327 U. S. 404, in which the Supreme Court affirmed the decision of this Court, where others have failed. None the less, certain important factors can be pointed out which, it is believed, should control the disposition of the instant case.

In the *Wilcox* case an embezzler was held not to have received gains or profits within the meaning of Section

22(a) of the Internal Revenue Code of 1939. The court held that a taxable gain is conditioned on two things: (a) the presence of a claim of right to the alleged gain, and (b) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. The bare receipt of money or property wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of Section 22(a). All right, title and interest in and to the money embezzled rested with Wilcox's employer. The debtor-creditor relationship was definite and unconditional and the employer had at no time condoned or forgiven the debt.

Interestingly enough in *Rutkin, supra,* the Court did not once mention "claim of right." Obviously the extortioner had no claim of right to the money and could assert none. The Court premised its decision of the fact that the taxpayer had gain, unlawful though it might be, because of his control over the money. The cash was delivered to the taxpayer in a manner which allowed him full freedom to dispose of it at will because under the circumstances the payor was unlikely to repudiate the transaction and demand return of the money. Unless he did so the taxpayer could enjoy its use as fully as though his title to it were unassailable.

It is extremely important to note that the issue of extortion arose in defense to an income tax fraud case where the taxpayer's defense to his failure to report the receipt of the money was that it did not constitute taxable income. No action had ever been instituted by the payor to recover the money. In fact, as pointed out in the lower court (189 F. 2d 431, 436) the payor had left the taxpayer in undisputed possession of the money for eight years and had permitted the statute of limita-

tions to expire on whatever right he might have had to reclaim the money.

The Supreme Court in *Rutkin* limited the *Wilcox* case "to its facts." Subsequent to the *Rutkin* case a number of cases have followed *Rutkin.* In *Kann v. Commissioner,* 210 F. 2d 247 (3d Cir. 1954), sums improperly obtained from a corporation by controlling taxpayers were held to constitute taxable income. This case involved certain income tax deficiencies and fraud penalties for the years 1936 through 1941. The defense was that the sums in question had been embezzled and thus did not constitute taxable income. The court followed *Rutkin.* It stated there was no external evidence of the crime of embezzlement. The taxpayers were never indicted or convicted nor did it appear that those concerned with the corporation's affairs ever urged prosecution. Nor was there any proof in this case that the method of taking the money had not been condoned or that there was in fact any liability to repay the sums taken. Further here the taxpayers were to a large extent taking their own money.

In *Briggs v. United States,* 214 F. 2d 699 (4th Cir. 1954), the taxpayer was authorized to procure bids on surplus lands which his employer desired to sell. He and another person entered into an arrangement to sell the lands at prices in excess of those reported to the company and pocket the difference. They operated this fraudulent scheme over a period of years during which each received in excess of $100,000, which he used as his own money. The company did not discover the fraud until after the individuals had been indicted for violation of the income tax laws. Obviously under these circumstances the taxpayer received money over which he had complete control with resulting economic value and for which he probably

never would have been required to account had it not been for the discovery of the fraud on the revenue.

In *Marienfeld v. United States,* 214 F. 2d 632 (8th Cir. 1954), the taxpayer had a contract with a company under which he was authorized to sell certain by-products from the boning of meat for the "account" of the company. He either failed to account for sales or reported sales for a smaller price than was actually the case. Upon audit of his income tax return for 1946 it was discovered that he had failed to report this money. His defense was that the money was embezzled and hence was not his income. The court held that the money so received was taxable income to the taxpayer and that the case was more nearly synonymous with *Rutkin* than *Wilcox* because of the nature of the taxpayer's possession, dominion over, opportunity for use of, and freedom to dispose of the funds in question. At most the taxpayer in this case had a deferred obligation to account for the funds which he collected.

United States v. Bruswitz, 219 F. 2d 59 (2d Cir. 1955), involved the failure of taxpayers to report bribes. The court commented on the cases discussed above following *Rutkin.* It stated at page 61:

> "* * * Certainly the whole approach of the later case [Rutkin], stressing actual possession and control, is diametrically opposed to the 'claim of right' criterion of the earlier case. [Wilcox] The reconciliation evolved by other circuits seems to be that even temporary dominion over illicit gains is sufficient to render them taxable in the hands of the holder thereof [citing cases.] Although eminently justified by the Rutkin holding, this formulation in effect does what the Supreme Court purported not to do; it overrules the Wilcox case. * * *"

The Court then distinguished this case from the *Wilcox* case on the ground that there was no indication that the kickbacks resulted in any loss to the taxpayers' employers. It stated that although a presumption of such loss may be a sufficient basis on which to predicate a liability to the employers under state law, it was not sufficient to override the paramount interest of the government in assessing income taxes on the basis of beneficial enjoyment and control.

Berra v. United States, 221 F. 2d 590 (8th Cir. 1955), also involved income tax evasion. The business manager of a labor welfare organization arranged with a painting contractor to overstate his bills to the organization. He then approved and paid the bills and received the amount of the overpayment from the contractor. He contended these sums were not income because embezzled from his employer. The court held these funds to constitute taxable income. The money did not come from the employer but from a third person. Taxpayer might have been guilty of obtaining money by a fraudulent scheme or device but not by embezzlement, and he had complete control over the money.

In *Estate of Dix v. Commissioner,* 223 F. 2d 436 (2d Cir. 1955), the Court followed *Wilcox* and held that money appropriated by the president from a closely held family corporation was not taxable income. This money had been withdrawn from corporate bank accounts without the consent, coerced or otherwise, of the company. This was a simple case of embezzlement, not one involving a receipt under any color of right. The government's request for a writ of certiorari was denied.

Finally *Alice v. Prokop,* T. C. Memo. 1957-75, involved the failure to report for income tax purposes

funds diverted from a union. The years 1944 through 1947 were before the Tax Court. The audit which disclosed the diversions was begun in 1947. At least a substantial portion of the funds were restored to the union in consideration of a written release from the union. The Tax Court distinguished this case from *Wilcox* on the ground that there guilt of the particular crime had been established and adjudicated. Here the defense of embezzlement was an affirmative one with no adequate proof that the offense had not been condoned.

The only generalization counsel can draw from the above cases is that normally for a person to be taxable with respect to a particular item of property or money he must hold it under a bona fide claim of right and without a definite, unconditional obligation to repay or return it.

However, in cases of illegal activities there patently can be no holding under a claim of right. In the face of this assertion by taxpayers who failed to report the money derived from such activities the courts have been presented with a dilemma. They have quite properly been unwilling to hold that such gain does not result in taxable income, and gain there manifestly was. To have done so would have given preferential tax treatment to dishonest taxpayers. It is submitted that the key to the courts' decisions and the underlying rationale of the cases is the factual situation surrounding the restrictions, if any, on the use of the money or property in question and the likelihood of the taxpayer having to restore the money to the lawful owner.

(c) All Relevant Facts and Circumstances Must Be Considered.

The court below considered the law so clear, as applied to these facts, that it did not even require discussion. Yet it is equally clear that all relevant facts and circumstances of each case must be considered. Further, the line of demarcation in these cases is far from being sharply etched, and the undisputed facts in this case do not fall into the normal pattern.

As was pointed out in *Wilcox,* the mere receipt of property or money which one is obligated to return or repay to the rightful owner does not result in the receipt of taxable income. There must be something more. Thus the receipt of a loan, even though the borrower may not intend to repay, does not result in receipt of income because the obligation to repay arises at the very instant of the borrowing. A debtor-creditor relationship exists. The same situation exists in the case before this Court.

As pointed out above, it is counsel's opinion that the key to the courts' decisions and the underlying rationale of the type of case with which we are here concerned is the factual situation surrounding the restrictions on the control over and use of the money or property in question by the taxpayer and the likelihood of the taxpayer having to restore the money or property to the lawful owner. In considering the relevant facts and circumstances in the instant case it would appear there was not present the requisite extent of control over and use of the moneys in question by the taxpayer herein. This is true because at the very moment taxpayer unlawfully converted the 320 shares of stock owned by Raichart there arose a continuing obligation to repay the value thereof to the true owner. This continuing obligation had

its genesis in the written agreement of transfer of said stock to Raichart and attached itself to said moneys in such a manner as to be a continuing restriction on the control and use thereof by the taxpayer.

And, as distinguished from the *Rutkin* case and the cases following it, not only was it very likely that the taxpayer would have to restore the moneys to Raichart pursuant to the written agreement, which was in the possession of the executrix of Raichart's estate, it was practically a foregone conclusion judging from the state court decision wherein it was said, in essence, that it would tax the imagination of the court to believe the taxpayer's testimony as to his alleged claim to the moneys. Furthermore, this suit by the executrix was instituted promptly and had no connection with, nor did it result from, the later tax case here under consideration. This suit is not a mere possibility herein raised for the first time as an affirmative defense as in cases following *Rutkin,* but is one of the actual facts and circumstances which must be considered as an integral part of the record in this case.

No problem of protecting the revenue exists in this case. In practically all of the cases following *Rutkin* the taxpayer has sought to avoid payment of income tax or imposition of fraud penalties by raising the affirmative defense that the money in question did not represent gain within the meaning of Section 22(a) of the Internal Revenue Code of 1939. Here the taxpayer paid tax on the gain. This may have been self-serving as it was consistent with his position in the state court litigation. None the less the income was reported. It would also be taxed again in 1953 to the owner of the income when the judgment was paid. All taxpayer is here contending is that he erroneously overstated his income in

1951 by the amount of the gain reported on the sale of this stock. It was not gain to him under Section 22(a) of the Internal Revenue Code of 1939 because the stock never was owned by him, and he never held the proceeds without restriction on their use and disposition. The reporting of the gain having been in error, the correct amount of tax due should be determined in this proceeding.

Nor is this a case where the taxpayer was in rightful possession of funds for which he ultimately failed to account properly to his principal. Here the obligation to pay over was immediate and instantaneous as clearly held in the state court proceeding. This is in no sense the type of possession, dominion over, opportunity for use of, and freedom to dispose of funds that existed in the *Rutkin* case and cases which followed that decision.

It appears unnecessary to point out that the acts of the taxpayer in this case in unlawfully converting Raichart's property to his own use were never condoned but that legal action was promptly instituted by the lawful owner long before the tax case developed.

Under all the facts and circumstances of this case it is respectfully submitted that taxpayers realized no gain in 1951 from the sale of the 320 shares of stock owned by Raichart's estate within the meaning of Section 22(a) of the Internal Revenue Code of 1939.

Conclusion.

The decision of the court below is clearly erroneous and should be reversed.

Respectfully submitted,

A. L. Burford, Jr.,

Attorney for Petitioners.

APPENDIX.

INTERNAL REVENUE CODE OF 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

Regulations 111:

Sec. 29.22(a)-1 (As amended by T. D. 5600, Feb. 2, 1948.)

What included in gross income.—

Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits and income derived from any source whatever, unless exempt from tax by law. (Sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237, inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property. * * *

The Civil Code of the State of California:

Sec. 2223. Involuntary Trustee; Thing Wrongfully Detained.

Involuntary Trustee, who is. One who wrongfully detains a thing is an involuntary trustee thereof, for the benefit of the owner.